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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1940

No. 691

CHICAGO AND NORTH WESTERN RAILWAY COMPANY and CHARLES M. THOMSON, Trustee of the Property of Chicago and North Western Railway Company,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION TO ALLOWANCE OF WRIT OF CERTIORARI

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TABLE OF CONTENTS

PAGE

No Duplicated Items 1

Commissioner in Allowing Office Building Duplication Waived His Own Regulation 2

Northern Pacific Case in Conflict with Decision Below 4

Government's Contention in Court of Claims Case Inconsistent with Decision Below 5

AUTHORITIES CITED

Northern Pacific v. *Helvering,* 83 Fed. (2nd) 508. 4

Revenue Act of 1926, Section 202, 44 St. L. 9. 5

Revenue Act of 1928, Section 111(b)(2), 45 St. L. 791 5

Regulations 69, Article 23 2

Regulations 74, Article 23 2

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NO DUPLICATED ITEMS

In the Government's brief in opposition, it is adroitly suggested (on pages 4 and 5) that if accorded the relief sought the taxpayer would benefit by double deductions. Reference is made (page 5) to the treatment of the large elevator rehabilitation items in 1921 and 1922. The inference is suggested that because of the deductions of $951,821.37 and $2,114,778.81, in 1921 and 1922, and the transfer of the latter amount by the Commissioner from 1922 to 1921, the taxpayer obtained an advantage that should preclude the relief now sought. The fact is, as the record abundantly demonstrates (for example, see Record p. 647, Exhibit

39), that the Commissioner's treatment of these items was inconsistent with his position in the present case and with the Government's argument, was contrary to the very method of accounting now relied on by him, and in addition considerably increased the taxes paid for 1921 and 1922. Moreover, these suggestions (on pages 4 and 5 of the Government's brief) ignore uncontradicted testimony that the calculations of the allowances claimed (Record pp. 497 ff., Exhibit 20) take full account of and reflect properly all counterbalancing items with respect to the leased elevators and docks, so that duplications have been eliminated.

In the case of the office building, the Commissioner himself had allowed depreciation, not only for 1927 and 1928, as the Government's brief states (pages 5 and 6), but for all years back to 1923 (Record pp. 647 ff., Exhibit 39), under the circumstances fully detailed in the record (pp. 285 ff.; p. 667, Exhibit 40; p. 669, Exhibit 41), at a time when that course appeared to be to the Commissioner's ultimate advantage. Presumably in the case of the office building, he took care of possible duplications when he made the allowance for all these years from 1923 to 1928. Though having the burden of proof as to this affirmative issue, he offered no proof to the contrary. The fact is that if the relief here sought is allowed, the taxpayer will have no advantage by way of improper duplications of deductions.

COMMISSIONER IN ALLOWING OFFICE BUILDING DEPRECIATION WAIVED HIS OWN REGULATION

The Government refers (on p. 7 of its brief) to the regulation [1] which provides that a taxpayer may change his method of accounting only by applying

[1] Regulations 69 and 74, Article 23.

for permission at least 30 days before the close of the taxable period, furnishing certain detailed information to the Commissioner. It is then said that "in view of the opportunities for eliminating entirely items of taxable income or for obtaining the same deduction twice, through a change of accounting methods, the foregoing regulations are reasonably calculated to safeguard the revenues". Before he allowed depreciation on the office building, the Commissioner presumably availed himself of his opportunity to prevent the taxpayer's "eliminating entirely items of taxable income" and "obtaining the same deduction twice". He did just what he would have done had application been made 30 days before the close of the taxable year. The time limit in his own regulations had, to be sure, not been complied with; but this was a mere administratively prescribed time limit of the Commissioner which he was at liberty to waive if he saw fit. At that time the waiver appeared to be favorable to the revenues. Yet, with no proof that he had erred in fact, and although he had the burden of proof, he was permitted by the tribunals below to obtain a reversal of his own former action, after the time had gone by within which he could make an administrative determination which the taxpayer, not he, would have the burden of upsetting. Plainly, if he had allowed this depreciation upon application by the taxpayer 30 days before the close of the taxable year, as expressly permitted by the Regulations, his action would have been unassailable by him after he issued his deficiency letter except for error in fact or fraud, in which case he, not the taxpayer, would have the burden of proof. Should the result be different merely because he waived his own administrative requirement?

One ground relied on for the allowance of the writ herein is that the tribunals below departed from the accepted and usual course of judicial proceedings by permitting a party having the burden of proof to prevail without introducing testimony necessary to sustain the burden. The Government's brief wholly ignores this important point. It cannot be that in a matter within the Commissioner's discretion his own action favorable to a taxpayer is wholly void merely because he himself has not insisted on strict compliance with a regulation promulgated by himself for his own administrative convenience. The Commissioner concededly may in his discretion, upon proper application and showing, permit a change of accounting methods. His action in the present case in retroactively allowing the office building depreciation cannot be wholly void merely because the permitted departure from the taxpayer's method of accounting was retroactive. At least with respect to the office building item the decisions below were plainly erroneous, even if the provision of the Regulations relied on sustains the result in the case of the other items.

NORTHERN PACIFIC CASE IN CONFLICT WITH DECISION BELOW

The Government asserts (brief, pp. 7-8), that the decision below is not in conflict with *Northern Pacific* v. *Helvering*, 83 F. (2d) 508 (C.C.A. 8th). It is stated (p. 8), that in that case "there was no controversy over the method of accounting employed." The fact is that in that case the taxpayer, although using "the average cost of the services if rendered to the public" as its method of accounting for the transportation costs there involved, claimed the right to employ a different method, the "out-of-pocket" method, for tax

purposes. The opinion makes it plain that there were these two "methods". The Board of Tax Appeals adopted the "average cost" standard. The court, after analyzing both methods, said it was "led to conclude that the proper measure for determining this transportation for construction cost is the 'out-of-pocket' method." Thereby it permitted a departure for tax purposes from the "method" employed by the taxpayer on its books and adopted by the Board. The decision below and the *Northern Pacific* case, *supra*, conflict; for in one case, the present one, the taxpayer was held bound as a matter of law by a "method of accounting" for which there is no affirmative statutory recognition, while in the *Northern Pacific* case the taxpayer was not compelled for tax purposes to follow the "method of accounting" it had itself used on its books.

GOVERNMENT'S CONTENTION IN COURT OF CLAIMS CASE INCONSISTENT WITH DECISION BELOW

The Government's brief (on pages 9 and 10) admits that in the case pending in the Court of Claims it seeks to treat retirement deductions as the petition states (on pages 17 to 20 of the petition herein). The inconsistency between the decisions below and the Government's position in this Court of Claims case is dismissed with the statement (brief p. 10) that "as to assets acquired prior to March 1, 1913, the same statute [1] requires that the basis be diminished by the amount of depreciation actually sustained before said date," and the further statement that "in accord with

[1] The section is not cited in the government's brief. Section 202 of the 1926 Act and Section 111 of the 1928 Act are obviously referred to.

this specific legislative requirement [1] the Government is contending in the Court of Claims case that the cost basis of assets acquired prior to March 1, 1913, must be depreciated down to that date in order to arrive at the fair market value as of March 1, 1913, the effective date of their income tax laws."

Yet earlier in its brief (on pages 6 and 7) the Government argues that "under the statute, petitioner is entitled to a 'reasonable allowance for the exhaustion, wear and tear of property' "; that either the straight line or the "retirement" method was proper; and (on page 4) that the taxpayer's income "was reflected clearly and with reasonable consistency by the use of this (retirement) method." Such reflection would, if true, have been equally true had no income tax law ever been passed. The Commissioner's case is bottomed on the statutory provision requiring "net income" to be "computed upon the basis of the taxpayer's annual accounting period" provided the method "clearly reflects the income." Retirement charges are admittedly deductible under the section of the law permitting deductions for depreciation, not the one relating to losses. Under the Government's theory herein and that of both opinions below, the section of the law relating to the determination of the "basis" for gain or loss is necessarily immaterial. The taxpayer's argument to the contrary was rejected below. Income is "reflected", so it is said, by the "retirement" method. If this is true, it is true without regard to March 1, 1913, or any other particular date. But under the Commissioner's admitted con-

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[1] The section is not cited in the government's brief. Section 202 of the 1926 Act and Section 111 of the 1928 Act are obviously referred to.

tention in the Court of Claims case (and evidently his policy in all similar cases) the depreciation allowance otherwise reasonable under the "retirement" method as reflecting income must be drastically reduced to reflect depreciation "sustained" prior to March 1, 1913. The deduction for depreciation if so reduced must necessarily become less than what otherwise in fact reasonably "reflects" income under the "retirement" method. This contention is contrary to the Government's theory in the present case and to the opinions of both tribunals below. If these opinions are right, the Commissioner is wrong in his contention in the Court of Claims case. If he is right in his contention in that case the statutory sections relating to the "basis" for gain or loss would, as the taxpayer argued herein, preclude retirement deductions, undepreciated, of such structures as are here involved, and as a corollary must entitle the taxpayer to current depreciation deductions. The excuse assigned in the Government's brief (p. 10) for the Commissioner's contention in the Court of Claims case is no more than an attempt to avoid the consequences of his own argument herein, and of the opinion below, in their bearing upon major problems of railroad roadway retirements. The inconsistency exists and cannot be thus lightly dismissed. At least there is sufficient basis for concluding that there is such inconsistency as to make this a proper case for a full review.

Respectfully submitted,

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